

## Government provides incentives to generate increased exploration activity

**14 June 2004 - The Crown has announced a package of incentives to increase the level of petroleum (gas and oil) exploration. A higher level of exploration is considered necessary to increase the probability that sufficient reserves of new gas will be found and brought to market in time to meet future gas demand, especially for the existing and prospective gas fired electricity generation and petrochemical industry needs.**

Concern about future gas supplies and electricity generation options is a significant energy infrastructure issue. There are insufficient gas reserves to meet projected demand from electricity generation beyond about 2015 (this date is subject to various uncertainties).

The energy market is evidently responding to the changing gas supply conditions, and exploration activity is expected to pick up. However, the speed and extent of that response remains uncertain and in the short term, may not be sufficient to significantly increase the probability of viable new gas discoveries to meet demand in the medium term.

Increasing the level of exploration over the next few years aims to reduce much of the uncertainty currently affecting the energy market.

Crown Minerals started a project towards the end of 2003 to investigate options that might lead to the discovery of new gas. This project involved other parts of the Ministry of Economic Development, Inland Revenue Department and Treasury. The Petroleum Industry via the Petroleum Exploration Association of New Zealand (PEANZ) and various upstream and downstream companies had input into the project. Independent financial and legal advice was provided towards the end of the consultation phase.

In evaluating options to encourage more exploration activity, the following aims and design criteria were used:

- Encourage increased exploration activity as soon as possible (be implemented quickly);
- Materially improve the economics and or/reduce risk for exploration and or production;
- Involve low compliance and administration costs;
- Minimise distortionary incentives or behaviours; and
- Be consistent with generic tax and other policies.

The proposed exploration initiatives include:

- Reducing the royalty rate for petroleum discoveries made from 30 June 2004 to 13 December 2009 for a given quantity of production and improving the deduction of exploration costs against accounting profits royalty provisions;
- Considering specific changes to tax regime, including: reviewing the tax treatment of off-shore operators (such as drilling rig and seismic survey ship operators), clarifying the GST treatment on sale of a permit interest by a person in a joint venture and on the costs of a site restoration, reviewing the amortisation rates for capitalised development costs; and
- Providing additional funding to Crown Minerals to acquire new geological and geotechnical information and to promote New Zealand exploration opportunities.

The impact of different proposals may span different timeframes. Refinements to the tax regime could have a long term impact while proposed changes to the royalty regime apply to a five year window, to encourage a burst of exploration activity. The exact value of this package cannot be determined as it depends entirely upon the success of explorers to make new discoveries.

Royalty based incentives:

Gas and oil producers pay two forms of royalty, an ad valorem royalty (AVR), which currently applies at a rate of 5% of gross revenue from the sale of petroleum, and an accounting profit royalty (APR), which currently applies at a rate of 20% of net revenues from the sale of petroleum, after deducting production expenses incurred under the same, or a related, permit. Permit holders are required to pay the higher of the two royalties in any year.

Proposed changes to the status quo will be managed through review of the Crown Minerals Programme for Petroleum. The proposed changes are detailed below:

- reducing the ad valorem royalty [AVR] rate from 5 per cent to 1 per cent for gas (oil will remain at 5 per cent) for discoveries made within the period;
- allowing a deduction in relation to the accounting profit royalty [APR] on production from discoveries, within the period, of exploration and prospecting costs incurred in New Zealand and allowing such costs to be carried forward with interest;
- reducing the accounting profit royalty (APR) from 20 per cent to 15 per cent on the first \$750 million [cumulative] gross sales of petroleum offshore and the first \$250 million [cumulative] onshore on discoveries within the period.

These proposed changes to the royalty regime are incorporated in the current review of the Minerals Programme for Petroleum. Towards the end of June 2004 this document will be released for public consultation. The document will also be posted on this website.

#### Tax Measures:

The industry already enjoys relatively favourable tax treatment compared to other industries in New Zealand. Government is considering a review of the tax treatment of non-resident operators such as rig and seismic ship operators to develop solutions to the issues around the taxation of these companies. This is referred to as the 183 day issue. Beyond reviewing the general tax treatment of non-resident operators, the cost of compliance will also be reviewed. Other tax based incentives that are proposed for review include;

- Clarifying the GST treatment on the sale of an interest in a permit by a person who is in a joint venture, and also the GST treatment on the costs of site restoration; and
- Reviewing the amortisation rate, or front-loading the amortisation profile of capitalised development costs, consistent with a reassessment of economic lives, and reviewing the different treatment of onshore and offshore drilling.

The Inland Revenue Department will conduct the review of these items and will consult with industry in the course of determining the final outcomes.

#### Marketing Initiatives:

A range of initiatives to proactively encourage E&P companies to New Zealand, and to facilitate more efficient and effective drilling programmes, will be explored. These include:

- funding pre-competitive data acquisition;
- facilitation/coodination of multi-party work programmes; and
- information provision to facilitate exploration.

#### Pre-competitive bidding data acquisition:

The government proposes funding a programme (managed by Crown Minerals) to increase understanding of the prospectivity of New Zealand's petroleum basins, spending up to \$15 million over two to three years. This will be developed in consultation with the industry and other interested parties and will be used to increase the knowledge base available to explorers, thereby increasing the attractiveness of New Zealand as an exploration destination.

To ensure acquisition of new data is not impeded, the Crown has placed a moratorium on AFO's (Acceptable Frontier Offers) for a period of three months to allow an orderly assessment of areas where new data will be acquired and areas where future competitive bidding rounds will be held.

#### More active programme facilitation by Crown Minerals:

All permit holders provide Crown Minerals with a detailed work programme that provides dates when specific activities such as seismic surveying and drilling are planned. Crown Minerals will use this information to assist with the coordination of these activities to ensure progress is not delayed due to shortages of technicians and equipment.

#### Facilitation of exploration activities:

Crown Minerals is currently developing a strategy to promote new investment, targeting a range of explorers that have a profile that is

appropriate for New Zealand. Activities to attract these explorers include providing appropriate information and working with market analysts equity investors and explorers.

This work requires preparing and presenting promotional material to explorers, market analysts and investors, managing appropriately structured block offers, and augmenting geotechnical information systems. Four key areas of work are:

1. Establishment and promotion of a new investment strategy;
2. Geo-technical data analysis and customisation;
3. Technical analysis of users' needs from information technology systems; and
4. Review and strengthening of the data compliance regime.